Information from the Division of Health Care Finance and Policy

FY02 Annual Acute Hospital Financial Report

About this Report

The Division of Health Care Finance and Policy publishes an annual acute hospital financial report in response to a legislative mandate to provide an annual assessment of financial trends in the acute hospital industry. The annual report is one part of the Division's ongoing program to better protect the public's interest by continuously monitoring the financial condition of acute hospitals. The report presents analysis of FY02 hospital data that has been reconciled to the hospitals' Audited Financial Statements,[1] and supersedes the Division's *Quarterly Acute Hospital Financial Report* which was published on this web site in December 2002.[2]

On an aggregate basis, the findings have changed very little—confirming the value of using the unaudited data to provide a snapshot of industry performance. In some cases, however, values for individual hospitals have changed significantly as a result of the hospital's year-end adjustments and audit process. Financial trends for individual hospitals can be seen on the updated Hospital Fact Sheets, also available on this web site.

Financial ratio analysis can provide useful information about a hospital's financial condition, especially over time. Three areas discussed in this report include profitability, liquidity and solvency.

Profitability

The Massachusetts acute care hospital industry is almost entirely non-profit, however, charity hospitals need to generate a surplus in order to remain liquid and solvent. Otherwise, hospitals would be unable to complete their mission, repay any debt, or invest in the future of their organizations. Three profitability ratios are reported here: operating margin, non-operating margin and total margin. Figures 1 and 2 on page 2 show 25th, 50th (median) and 75th quartile values[3] for operating margin[4] and non-operating margin[5] trends for FY98 through FY02. Figure 3 on page 2 presents the same information for total margin.[6]

Although total margins dipped slightly, primarily due to non-operating losses, operating margins improved across the industry in FY02. Hospitals' median operating margin was positive, indicating a small surplus for the first time in five years. In FY01, 53 percent (36 hospitals) had negative operating margins. In FY02, 47 percent (32 hospitals) had negative operating margins. Although the distribution of operating margin across hospitals is narrowing, with fewer high- and low-end hospitals, there is still a wide range in hospital performance, with some hospitals showing healthy operating margins and others showing worrisome operating losses. Likewise, median total margin, although smaller, still remains pos-

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[1] This report is based on 12 months of FY02 data for 68 short-term acute hospitals. Data for 58 of the hospitals has been reconciled to the Audited Financial Statements.

[2] Depending upon the organization of each hospital, these data may exclude other aspects of some hospitals' financial health, such as performance of endowments or the financial health of parent or other affiliated organizations.

[3] Quartile values can shed light on information about the distribution of financial ratio values across hospitals. Often, averages can be materially affected by outlier/extreme values at the low and high ends of a distribution. Examining quartiles, therefore, is a preferred means of assessing the overall distribution of values across hospitals. For instance, the ratio values of one quarter of the hospitals at the low end of the distribution will fall at or below the 25th quartile value. Similarly, the ratio values of one quarter of the hospitals at the high end of the distribution will fall at or above the 75th quartile value. The 50th percentile is the median, or the center of the distribution of values. Half the hospitals' financial ratio values will fall below the median, and half will fall above the median. These quartile measures are particularly useful when a distribution is markedly skewed, or where it is generally symmetrical but includes a few extreme values at one end (outliers).

[4] Ratio of operating income to total revenue.

[5] Ratio of non-operating income to total revenue.

[6] Ratio of total income to total revenue.

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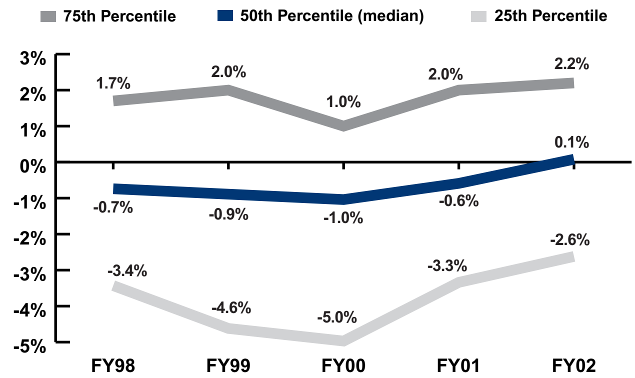
Figure 1

Operating Margin Trend, FY98-FY02



- **Median operating margin is positive (though small) for the first time in five years.**
- **In FY02, operating margin in all three quartiles improved, although it is still negative for the bottom quartile. This indicates that the industry as a whole improved; further, 47 percent of the industry (32 hospitals) had negative operating margins in FY02, compared to 53 percent (36 hospitals) in FY01.**

itive, with a narrowing distribution. The number of hospitals with negative total margins remained fairly stable (approximately 40 percent, or 27 hospitals) over the past year.

Liquidity

Liquidity ratios indicate hospitals' ability to meet their short-term obligations. Deterioration of these ratios is often the first indication that there are problems in the financial health of an organization. Three liquidity ratios are reported: Current Ratio,[7] Average Days in Accounts Receivable[8] and Average Payment Period.[9] Figures 4, 5 and 6 on page 3 show trends in quartile values for these three ratios. In general, liquidity improved for most hospitals in FY02. The Current Ratio (shown in Figure 4) increased for most hospitals. Most hospitals are also still above the 1.0 benchmark.[10]

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[7] Ratio of current assets to current liabilities.

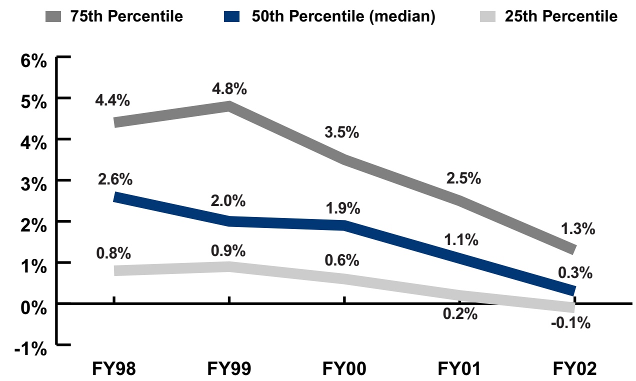
[8] Ratio of net patient accounts receivable to total revenue/365.

[9] Ratio of current liabilities less estimated 3rd party settlements to total expenses less depreciation and amortization/365. Both ratios of Days in Accounts Receivable and Average Payment Period exclude estimated 3rd party settlements due to the year-to-year volatility of these estimates.

[10] A Current Ratio value of 1.0 indicates that a hospital can cover all its current liabilities with its current assets. Values below 1.0 are considered unfavorable.

Figure 2

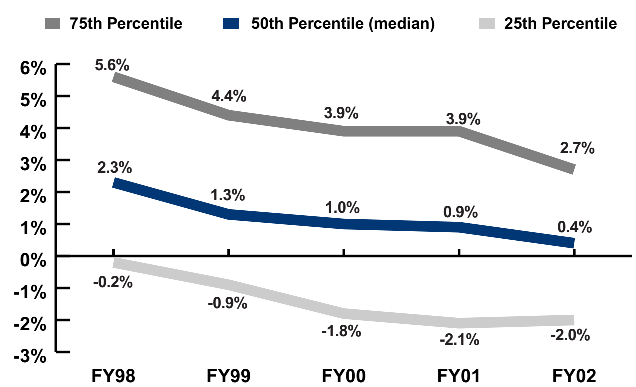
Non-Operating Margin Trend, FY98-FY02



- **Non-operating margins for the industry as a whole deteriorated in FY02, presumably because of investment results and the economy, generally.**
- **The distribution of non-operating gains across hospitals is narrowing, with approximately three-quarters of the hospitals experiencing negligible non-operating gains and 28 percent of the hospitals experiencing non-operating losses. This marks the first year of non-operating losses for some hospitals, and underscores the adverse effects of investments on hospitals' non-operating activities.**

Figure 3

Total Margin Trend, FY98-FY02



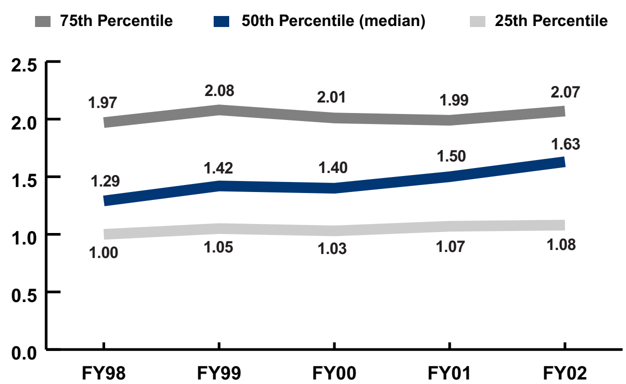
- **Median total margin is positive in FY02, indicating an overall surplus for the acute hospital industry. The hospitals in the 25th percentile, however, are still negative, although slightly improved over the previous year.**
- **The continued decline in the magnitude of median total margin (despite modest increases in operating margins) is due to the worsening of Massachusetts acute hospitals' non-operating margins.**

Hospitals' Average Days in Accounts Receivable (shown in Figure 5) improved in FY02, which indicates that most hospitals were paid sooner. Finally, the average time it took hospitals to pay bills (shown in Figure 6) decreased for most hospitals, most likely indicating improvements in Cash Flow in FY02.

Solvency

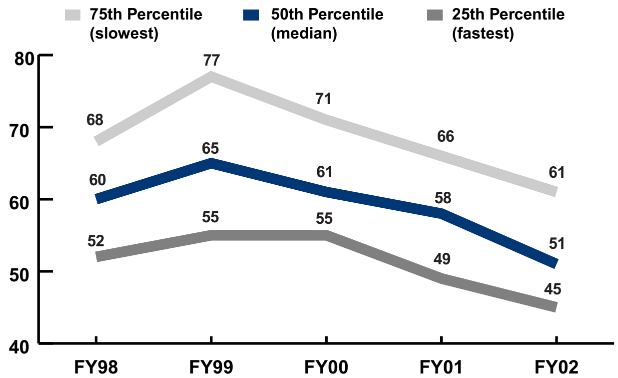
These ratios are useful in assessing the long-term solvency of hospitals and their ability to increase their debt financing. Evaluation of these ratios often determines the amount of credit available, and hence the growth potential of hospitals. Two solvency ratios are reported: Cash Flow to Total Debt[11] and Debt Service Coverage Ratio.[12] In general, the Cash Flow to Total Debt Ratio, which measures hospitals' ability to meet both their current liabilities and their long-term debt with funds from all sources, decreased from the previous year. Debt Service Coverage, which measures whether hospitals can meet their principal and interest payments only, has shown a modest decline, although the 25th percentile hospitals remained stable and the 75th percentile hospitals showed improvement.

Figure 4
Current Ratio Trend, FY98-FY02



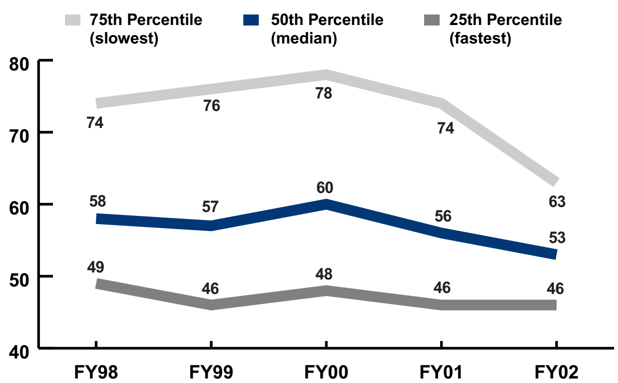
- **Median Current Ratio shows a slight increase in FY02 for most of the industry and is well above the 1.0 benchmark.**
- **The 25th percentile is at 1.1. While close to the 1.0 benchmark, the 25th percentile group has remained relatively stable for the last five years.**

Figure 5
Days in Accounts Receivable Trend, FY98-FY02



- **All three quartiles show an FY02 decrease in Days in Patient Accounts Receivable, a favorable trend. This indicates that hospitals are converting their receivables to cash more quickly, i.e. they are being paid somewhat sooner and/or their collection process has improved.**

Figure 6
Average Payment Period Trend in Days, FY98-FY02



- **Although Median Average Payment Period remained stable for the fastest paying group of hospitals, this ratio decreased for the majority of hospitals, most likely indicating improvements in Cash Flow in FY02.**

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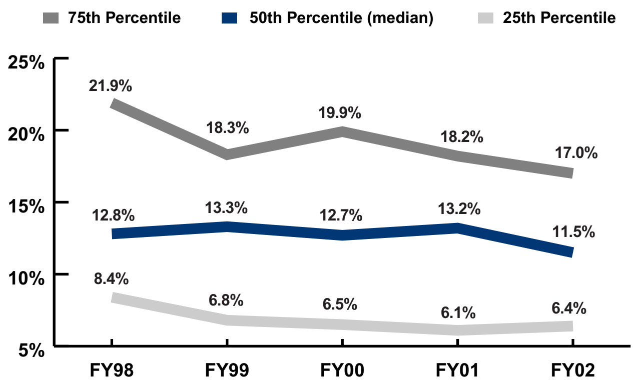
[11] Ratio of total income plus depreciation and amortization to total current liabilities plus total long-term debt.

[12] Ratio of total income plus interest expense plus depreciation and amortization to interest expense and current portion of long term debt.

Figure 7

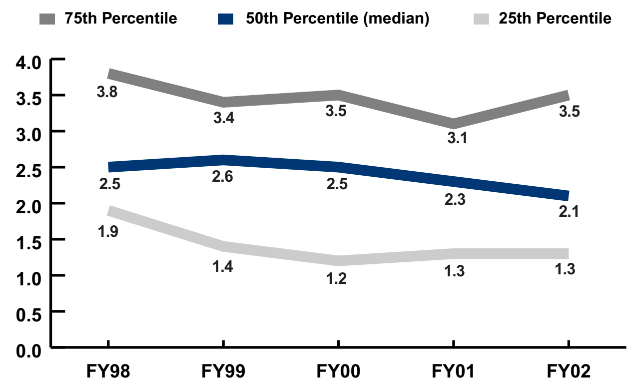
Cash Flow to Total Debt Ratio Trend, FY98-FY02



- **For the median group, and hospitals in the 75th percentile, Cash Flow to Total debt shows a slight decline from FY01 to FY02, indicating a minor worsening of hospitals' long term solvency. For hospitals in the 75th percentile, the decrease in solvency can be attributed to an increase in total debt.**
- **For those hospitals in the 25th percentile, Cash Flow to Total Debt improved slightly. In general, however , the poor Cash Flow to Total Debt values for this group can be attributed to poor profitability**

Figure 8

Debt Service Coverage-Total Ratio Trend, FY98-FY02



- **Total Debt Service Coverage Ratio improved slightly for the 75th percentile hospitals, but fell slightly for the median group in FY02. The ratio is still well above the benchmark of 1.5, however, indicating that hospitals continue to be able to meet their current interest and principal payments on debt.[13]**
- **While improving slightly, the ratio for the bottom 25 percent of hospitals is still below the industry benchmark.**

Summary

Operating profitability improved across the industry in FY02. The industry median increased and was positive for the first time in five years. In addition, the percentage of hospitals with negative operating margins decreased from the previous year. Non-operating margins continued to decline due to unfavorable financial market conditions and the economy. Nevertheless, total margin for the majority of the industry was positive, although lower than the previous year. Hospitals' liquidity position remained fairly stable or improved somewhat when measured by the Current Ratio, Days in Accounts Receivable and Average Payment Period. Solvency ratios declined slightly on an industry-wide basis, although they were more than adequate for at least the majority of hospitals. For the hospitals in the lower 25th percentile, however, solvency is of concern, as indicators are below industry benchmarks.

Financial ratio values for each hospital may be found on Hospital Fact Sheets at www.mass.gov/dhcfp/pages/dhcfp222.htm. Hospital-specific dollar surplus or loss, net patient service revenue and total net assets are also provided on each Hospital Fact Sheet to give the reader a sense of the magnitude of hospital surplus and loss, the size of operation, and the size of reserves.

[13] William O. Cleverly, Essentials of Health Care Finance, Fourth Edition, Copyright @ 1997 by Aspen Publishers, Inc.